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FOMC Chart Show Presentation -- International Developments

The first international chart summarizes the outlook for the external sector of the U.S. economy. The message depicted in the top panel has not changed fundamentally since January. We are projecting a continued deterioration of the current account balance; it will exceed \$200 billion and 2-1/2 percent of GDP in 1998. Our basic story has not changed either. Despite the positive influence on our exports of faster growth abroad, a "dollar [to quote a prominent Washington personality] that has been strong for some time now," U.S. growth that slows only gradually to around potential, and our existing deficit position produce a widening gap between imports and exports of goods and services; our deficit on net investment income expands as well.

As is shown in the middle left panel, the growth of real exports (black line) increased late last year and early this year in response to the recovery of foreign activity and the lagged effects of the weaker dollar in 1995. Export growth is expected to continue very strong through much of this year but to drop back in 1998 as the effects of the recent strength of the dollar are felt with greater force. Meanwhile, the growth of imports (red line) is expected to more than keep pace with that of exports; imports are being boosted this year by the rapid expansion in domestic demand and by the stronger dollar (which feeds through to imports more rapidly than to exports). Next year, import growth should ease off somewhat as the expansion of the U.S. economy slows toward potential and the influence of relative prices shifts toward neutral with the slight downward drift of the dollar. As is shown in the box at the right, real net exports of goods and services are projected to make negative contributions to the growth of real GDP throughout the projection period.

In the balance of my portion of our presentation I focus on the three issues listed at the bottom of the chart: our thinking about exchange rates, the foreign outlook and implications for

U.S. exports, and developments affecting prices and quantities of U.S. imports.

The next chart addresses the first of these issues. Based on the evidence of the past five months, the foreign exchange value of the dollar in terms of other G-10 currencies appears to have reached a high plateau. As is shown in the top left panel, the rise in the dollar since its trough in mid-1995 has been associated with a relative rise in U.S. real 10-year interest rates. Over the forecast period, we are projecting a slight downward drift in the dollar reflecting the net effect of the four influences on the dollar listed in the box at the right.

First, we think that our widening external deficit will put downward pressure on the dollar, though we are far from confident about timing or magnitude.

Second, more rapid inflation in the United States than in other G-10 countries also will tend to depress the dollar in nominal terms (the red line at the left), but it will translate into a smaller depreciation on a price-adjusted basis (the black line) because of higher U.S. inflation than in other G-10 countries; put another way, in the absence of the dollar's projected nominal depreciation, it would appreciate in real terms and further weaken our external position.

Third, the differential in real long-term interest rates (the blue line) is expected to have a neutral effect on the dollar. We have a very slight upward tilt in the path of real long-term interest rates in foreign G-10 countries. The slight wiggles in the differential reflect primarily the projected path of U.S. long-term interest rates.

The middle left panel illustrates, for three representative countries, how three-month rates are expected to creep up in response to their strengthening expansions. In Canada, increases in interest rates continue to keep pace with increases in U.S. interest rates. In Japan, as the expansion matures, we are assuming that interest rates will begin a gradual rise from the abnormally low level that has prevailed for almost two years. In Germany, we are assuming that short-term rates will rise about 75 basis points in the run-up to the start of EMU. However, under this scenario, German real and

nominal short-term interest rates still will be well below their average of the past several decades when monetary policy is handed over by the Bundesbank to the European Central Bank -- a point to which I will return in a moment.

This brings me to the fourth influence on the dollar, European Monetary Union. We are now assuming that a broadly based EMU will start on January 1, 1999, with the initial participation of 11 of the current 15 members of the European Union. Italy, Spain and Portugal will be in; Denmark, Greece, Sweden and the United Kingdom will be out, or stay out. The Maastricht treaty reference values for 1997 fiscal deficits will be missed or fudged by most major participants. In the run-up to EMU, at least, these factors plus an increase in general uncertainty will tend to continue placing downward pressure on the EMU currencies relative to the dollar, everything else being equal.

Pulling all these influences together, we are projecting, as you can see in the middle-right panel, that the dollar will remain essentially unchanged against the DM over the projection period -- the negative influence on the dollar of our widening external deficits is outweighed by the positive influence, so to speak, of EMU. The dollar depreciates substantially against the yen by the fourth quarter of 1998; in this case, the influence of external balances -- including importantly the rising Japanese surplus -- predominate. Finally, the U.S. dollar is projected to depreciate moderately against the Canadian dollar.

To complete our exchange rate story, the bottom panels look at non-G-10 currencies. The black and blue lines show that in real terms the G-18 index tends to track movements in the G-10 index. For the eight non-G-10 currencies -- two Latin American and six Asian -- the trend of the dollar has been one of gradual real depreciation, a trend that we expect to continue on balance. This trend principally has been associated with the fact that inflation in these countries has been somewhat more rapid than in the United States while most of their nominal exchange rates are closely tied to the dollar. A partial exception to this generalization -- the Mexican peso -- is shown at the right. Since

the dollar's substantial real appreciation against the peso in early 1995, it has retraced a good portion of the rise because the large differential between Mexican and U.S. inflation has outweighed the dollar's moderate further nominal appreciation against the peso. However, we are not projecting a continuation of this pattern. As indicated, the real peso/dollar exchange rate is expected to remain essentially unchanged over the next 18 months, as the dollar's nominal appreciation keeps pace with the inflation differential.

Turning to the foreign outlook, the subject of Chart 5, the top left panel illustrates the recovery since late 1995 in growth in both foreign G-7 countries and developing countries. As is shown in the box at the right, we are projecting fairly strong growth in Japan and Canada this year and next, while growth in the United Kingdom is projected to slow in 1998 under the influence of tightening monetary policy. Meanwhile, growth in our presumptive 11-country "Euro Area" is projected to average about 2-3/4 percent, somewhat faster than our estimate of their potential growth on average.

With respect to the developing countries, we expect a slowing of growth in Mexico and the rest of Latin America following very strong performances last year; indeed, a slowdown in the first part of this year already is evident. We also are projecting a modest slowing in growth (on average) in developing countries in Other Asia. So far this year, lower growth has been recorded in Korea and Taiwan. There is a larger than normal downside risk to our forecast for this region given the uncertainties associated with the influence of the yen on their exports, weaknesses in some domestic financial systems, potential spillovers from Thailand's problems, and the transfer earlier today (their yesterday) of sovereignty over Hong Kong.

As shown in the middle left panel, consumer price inflation abroad is projected to be low, or in Mexico's case declining.

The box at the right provides a perspective on output gaps in the foreign industrial economies.

As you can see, we estimate that the Japanese output gap will be reduced substantially by the end of the forecast period; this reflects our assumption that growth of potential output in Japan is about 2 percent and our projection that actual Japanese growth will average about 2-1/2 percent over the forecast period. Canada's output gap is projected to narrow more rapidly, but to remain somewhat larger than Japan's at the end of the period.

In the case of the United Kingdom, our estimate of the level of potential output may well be conservative in view of last Friday's substantial upward revision in the level of actual output. The new data on actual output and our previous estimate of potential output suggest that the British output gap already was more than eliminated by the end of 1996. However, our new estimates of potential and the output gap, displayed in the box, imply that some slack remained at the end of last year; this result at least makes the favorable recent U.K. price performance a bit more plausible.

The Euro Area presents an interesting case in the context of the start of EMU. We estimate that the output gap for the area as a whole still will be substantial -- more than a percentage point -- when the European Central Bank opens its doors in early 1999. However, our judgment is that there will be relatively little slack in Germany. At the same time there will be a larger amount in France, and output in Italy and Spain (not shown) will be significantly below potential. Taking our estimates at face value, one can speculate about two questions: Will the Bundesbank endeavor to put in place a less accommodative stance of monetary policy than we have assumed before it hands over the reins of monetary policy to the European Central Bank? In setting policy during 1999, how much weight will the ECB give to conditions in Germany versus other countries? We will not fully confront the implications of these issues for our forecast until we extend it into 1999, but they are some of the uncertainties that will weigh on the euro in the period ahead.

Turning to our forecast for U.S. exports, the solid black bars in the bottom panel show that we are projecting the continuation of a healthy expansion of total exports of goods and services both this

year and next. The other bars show the contributions of various categories of exports to the growth of the total. In recent years, the major contributions have come from exports of computers and semiconductors (the black, cross-hatched bars) and exports of other goods (the open red bars). In 1996 and so far in 1997, exports of other goods increased substantially more than our model's prediction. This suggests a source of risk to our forecast; we chose a middle road and implicitly assumed that the growth of these exports reverts to the historical rate. We have not assumed a reversal in the positive surprise -- about half of which is attributable to a higher rate of aircraft shipments than we expect to be sustained. In 1998, given the additional negative lagged effects of the recent strength of the dollar, the contribution of other goods exports to the growth of the total shrinks dramatically; exports of computers and semiconductors more than account for the overall growth we are projecting.

The final international chart deals with U.S. imports, both prices and quantities. With respect to prices, the heavy red line in the top left panel shows that prices of total manufactured imports have been on a declining trend since the second half of 1995, led by declines in prices of imports from Japan and the NIEs as well as from Canada and, more recently, the European Union. As indicated by the red line in the right panel, import prices have declined over the past year or so. As shown by the bars, the estimated contribution of exchange rates to that decline has been considerable. Declining import prices, in turn, have tended to hold down overall U.S. inflation by a few tenths in recent quarters. This favorable influence of the dollar, through import prices, on U.S. inflation is projected to be eliminated, if not reversed, over the period ahead.

The red lines in the middle panels depict actual and projected growth in quantities of goods imports -- excluding oil, computers and semiconductors. The contribution of relative prices (on the left) is to boost the growth of imports somewhat this year, but they become a neutral factor by the end of next year. The predominant influence (shown at the right) is the pace of expansion of U.S. GDP.

The bottom panel presents another cut on recent and projected trends in the pattern of overall growth of imports of goods and services. As in the case of exports, growth in the total (the solid black bars) is dominated by computers and semiconductors (the black, cross-hatched bars) and by other goods (the open red bars). The contributions to growth of the total from imports of services and oil are relatively minor. As U.S. GDP growth slows in 1998, the contribution of imports of computers and semiconductors to the growth of the total will remain high in absolute terms and rise in relative terms. The contribution of imports of other goods shrinks.

Larry Slifman will now continue our presentation.